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FACTSHEET

Income investment strategies

Yield on equities and corporate bonds look understandably attractive

People are living longer. Simple demographics mean that supplementary income is no longer a luxury – it's a necessity. Meanwhile, interest rates are at historic lows – even before you take account of inflation. So, relative to cash, the yield on equities and corporate bonds looks understandably attractive.

When you invest, you usually do so with two goals in mind: to grow the value of your money and/or to generate an income from that money. While many investments aim to do both, you may wish to choose funds that are more focused on one goal or the other, depending on your personal reasons for investing.

VERY REWARDING OVER TIME

If you are earning an income on your investments, and you don't need that income right away, reinvesting the payments has proven to be very rewarding over time.

The chart shows the effect of reinvesting income earned from UK shares over the ten years to July 2016. As you can see, the difference between how much your investments would have grown with or without your income reinvested is significant. Also known as 'compounding', this concept can be equally applied to interest earned on a savings account.

USING YOUR INCOME IMMEDIATELY

You may be ready to retire and want to use your income immediately instead. This might be to supplement a State Pension, to help pay monthly bills, to cover health care costs or to fund a bit of travel.

If you're taking an income, the important thing to remember is that different products will pay income at different times – monthly, quarterly or annually, for example – and it may not be a guaranteed amount. This is particularly important if you plan to pay bills with your income.

TAX-EFFICIENT INVESTMENT WRAPPER

You may also want to consider holding your investment within an Individual Savings Account (ISA) wrapper, as you won't then have to pay any tax on your income. Whichever way you choose to go, the company looking after your investment can either pay out your income to your bank account or reinvest it automatically.

Cash savings accounts, which pay an income in the form of an interest rate, can vary widely, but they generally fall into one of two categories: easy access or fixed-term savings. They can also be held inside or outside an ISA wrapper. Easy access accounts tend to have lower interest rates, while fixed-term accounts usually pay a higher rate but you'll have to lock in your savings for a specified time period.

GLOBAL FINANCIAL CRISIS

Nearly a decade ago, cash account interest rates were very attractive, offering as much as 10% at their peak before the global financial crisis. However, since the Bank of England lowered interest rates to 0.5% in March 2009, decent rates of interest on savings accounts have been hard to find.

The benefit of investing in cash is that your money is guaranteed. However, if the interest rate is lower than inflation (as some currently are), the real value of your money will be eroded over time. Investing in bonds or equities may help you to get better potential returns over time.

BONDS

Bonds can be issued by governments or companies (the issuer) and are essentially a way of that government or company borrowing money. Investors buy the bonds, and therefore become the loaners. In return, they typically receive a regular income (or 'yield' as it is more commonly called in the bond space) for a fixed period of time, and then get their money back at the end of that period.

There are three main types of bonds: government bonds, company or corporate bonds, and emerging market bonds (issued by either governments or companies in emerging markets).

UNABLE TO REPAY DEBT

Regardless of which type of bond you invest in, it is important to remember that yield can fluctuate throughout the period, and, unlike cash savings accounts, your money is not guaranteed. This is because you are loaning money as opposed to just locking it away, and, if the government or company is unable to repay their debt at the end of the time period, you could lose that money.

In practice, if you buy bonds from stable developed country's governments, the chances of your money not being repaid are almost non-existent (although the rate of income you receive may not be very high). Two of the most common types of government bonds are UK government bonds (known as 'gilts') and US government bonds (known as 'treasuries').

HIGHER RATE OF INCOME

If you want a higher rate of income, you might consider buying bonds from more emerging economies' governments, like certain South American or Asian nations perhaps. The trade-off is that you run a higher risk of your money not being repaid at the end of the bond's fixed term.

Alternatively, you might buy bonds from a company. Also known as 'corporate bonds', these tend to come in two categories: investment grade and high yields. Investment grade bonds are deemed to be better quality and less risky than high yield bonds.

SAFER OR RISKIER THAN OTHERS

To help you decide which bonds are safer or riskier than others, they are given a credit rating from AAA (the least risky) to C by credit agencies including S&P, Moody's and Fitch.

Because bonds and bond risks can actually be quite complex and difficult for individual investors to access, the best way to buy some

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bonds for your portfolio may be to invest in bond funds. You can choose between funds that invest in a mix of all the different types of bonds or funds that specialise in one particular type.

EQUITY INCOME

Another way of obtaining an income is from dividend payments on equity (share market) investments. Companies listed on the stock market may pay dividends as a way of distributing some of their profits back to their shareholders.

You might choose to buy shares in these companies directly in order to receive that income. Or, as with bonds, you may find it easier to invest in equity income funds. Generally, the managers of these funds scour the market to find what they consider to be the highest quality companies paying out sustainable, growing dividends. This means you get the benefit of a portfolio of companies in a single purchase – plus the managers do the work of monitoring and perhaps deciding to sell underperforming investments or buy companies that look promising.

FUND'S HISTORICAL YIELD

If you buy an equity income fund, the fund will amalgamate the dividends it receives from all the companies in which it invests into a single income payment for its investors. This may be paid monthly, quarterly, half-yearly or even annually. Some funds will indicate an expected income (or yield) target. Or, you may be able to get an idea of the level of income you can expect by looking at a fund's historical yield, but of course past performance is no guarantee of future returns.

UK companies have a very strong dividend-paying history, and so UK equity income funds have been a popular form of income investment for many years. Unfortunately, the past couple of years have seen several of our largest companies forced to reduce or suspend dividends in the face of falling profits, but many Elite Rated UK equity income funds have continued to deliver strong returns throughout this period.

DIVERSIFYING EQUITY INCOME PORTFOLIOS

Companies in other countries are also starting to understand the importance of returning value to shareholders, and we are seeing more and more foreign companies starting to pay a dividend. This has resulted in more overseas equity income funds becoming available, which means investors can better diversify their equity income portfolios.

It is important to remember that companies do not have to pay dividends (even if they have done so in the past), and so equity income is by no means guaranteed. Likewise, if you buy a fund, the yield can fall. Additionally, because your money is invested in shares – as opposed to a cash savings account or bonds – its value may also move up or down, so the risk of losing your money is greater than with bond funds. ■

COMPREHENSIVE INVESTMENT SOLUTIONS

Whether you are looking to invest for income or growth, we can provide the quality advice, comprehensive investment solutions and ongoing service to help you achieve your financial goals. To find out more, please contact us.